

BOARD OF WATER SUPPLY of the COUNTY OF KAUA'I

SPECIAL BOARD MEETING

Second Floor, Microbiology Lab Bldg
Kaua'i County Department of Water
4398 Pua Loke Street, Lihu'e, Kaua'i, Hawai'i 96766

MONDAY, NOVEMBER 19, 2012

9:00 a.m.

Or soon thereafter

A. CALL TO ORDER

B. ROLL CALL

C. ACCEPTANCE OF AGENDA

D. NEW BUSINESS

1. Draft Annual Audit

E. EXECUTIVE SESSION

Pursuant to H.R.S. §92-7(a), the Board may, when deemed necessary, hold an executive session on any agenda item without written public notice if the executive session was not anticipated in advance. Any such executive session shall be held pursuant to H.R.S. §92-4 and shall be limited to those items described in H.R.S. §92-5(a).

F. ADJOURNMENT

Department of Water, County of Kauai
Board/Finance Committee Presentation
November 19, 2012
Audit Date: June 30, 2012

- I. Financial Audit of the Department's Basic Financial Statements:**
 - a. Audit Scope
 - b. Financial Statement Highlights:
 - i. Unqualified (clean) opinion
 - ii. Basic Financial Statements
 - iii. Footnote Disclosures

- II. GAGAS Report:**
 - a. Report on Internal Control Over Financial Reporting and on Compliance and Other Matters
 - b. Summary of Findings
 - i. Current year findings
 - ii. Status of prior year findings

- III. Other Required Communication**
 - a. Letter communicating results will be sent – highlights are discussed below
 - b. Audit adjustments
 - c. Significant discussions with management
 - d. Difficulties encountered in performing the audit

- IV. Open Discussion, Questions or Comments**

**Department of Water
County of Kauai**

Financial Statements
As of June 30, 2012 and 2011
Together with Independent Auditor's Report

DRAFT

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Independent Auditor's Report

To the Board of Water Supply
Department of Water, County of Kauai:

We have audited the accompanying basic financial statements of the Department of Water (the Department), a component unit of the County of Kauai, Hawaii, as of and for the years ended June 30, 2012 and 2011, as listed in the table of contents. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2a, the financial statements present only the Department and do not purport to, and do not, present fairly the financial position of the County of Kauai, Hawaii, as of June 30, 2012 and 2011, and the changes in its financial position, or, where applicable, its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our report dated December 7, 2011, our opinion on the 2011 financial statements was qualified because of a departure from accounting principles generally accepted in the United States of America since the Department recorded payments in excess of pay-as-you-go requirements as contributions recorded against its net other postemployment benefits (OPEB) obligation. The payments in excess of pay-as-you-go requirements should have been treated as a deposit and not included as contributions in the related disclosures to conform with accounting principles generally accepted in the United States of America. As described in Note 9a to the financial statements, the Department's financial statements currently conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 2011 financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department of Water, as of June 30, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated [DATE] on our consideration of the Department's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis and the schedule of funding progress for the Hawaii Employer-Union Health Benefits Trust Fund on pages 3 through 7 and page 38, respectively, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying supplemental information included in Schedules I and II is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the accompanying supplementary information in Schedules I and II is fairly stated in all material respects in relation to the financial statements as a whole.

KMH LLP

Honolulu, Hawaii

[DATE]

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2012

The Department of Water of the County of Kauai is a semi-autonomous agency consisting of a Board of Water Supply, Manager and Chief Engineer, and support staff. The Board of Water Supply is responsible for the management, control, and operation of the County of Kauai's water system. This discussion and analysis is designed to assist the reader in focusing on the significant financial issues and activities and to identify any significant changes in financial position. We encourage readers to consider the information presented here in conjunction with the financial statements.

Financial Highlights

- Total assets at fiscal year-end were \$279.7 million and exceeded liabilities by \$170.3 million.
- Total net assets increased \$21.2 million or 14% and is basically the result of the current year's operations and capital contributions.
- Total cash and investments at June 30, 2012 were \$59.8 million and decreased by \$15.7 million.
- The Department's liquidity ratio is 2.2 for FY 2012 and 1.3 for FY 2011.
- The debt to equity ratio, including capital leases, is 59% for FY 2012 and 69% for FY 2011.
- Operating revenues for FY 2012 were \$22.5 million, an increase of \$1.7 million and is primarily attributable to an increase in the water rate and charges.
- Operating expenses for the current year totaled \$20.4 million, an increase of approximately \$2.7 million in comparison to the prior year. The major components of the increase are discussed later.
- Long-term debt has decreased by \$1.6 million, or 1%. The result is a combination principal payments made to long-term debt of \$2 million net of additional borrowings through State Revolving Fund loan agreements with the State of Hawaii Department of Health of approximately \$205,000. The Department issued through the County of Kauai \$5.1 million in general obligation bonds for the purpose of refunding the outstanding 2001A Series bonds.

Overview of the Financial Statements

The financial statements are presented using the economic resources measurement focus and accrual basis of accounting, whereby revenues and expenses are recognized in the period earned or incurred. The financial statements are designed to provide readers with a broad overview of the Department's finances in a manner similar to a private-sector business.

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2012

The basic financial statements include a statement of net assets, a statement of revenues, expenses and changes in net assets, a statement of cash flows, and notes to basic financial statements. The statement of net assets presents all of the Department's assets and liabilities and provides information on the nature of its resources and obligations. The statement of revenues, expenses and changes in net assets presents the results of operations and the resulting change in net assets for the year. The statement of cash flows presents changes in cash resulting from operating activities, capital and related financing activities, and investing activities.

The notes to the basic financial statements provide required disclosures and additional information that is essential to a full understanding of the data provided in the basic financial statements. In addition to the basic financial statements and accompanying notes, this report also presents certain supplementary information on utility plant in service and selective account classifications.

Financial Analysis

Statements of Net Assets - Condensed
June 30, 2012 and 2011

	2012	2011	% Change
Assets:			
Current and Other Assets	\$ 31,284,920	\$ 28,106,317	11%
Capital Assets, net	211,436,207	184,962,982	14%
Other Non-current Assets	37,002,927	54,557,946	(32%)
Total assets	<u>\$ 279,724,054</u>	<u>\$ 267,627,245</u>	5%
Liabilities:			
Current Liabilities	\$ 10,696,213	\$ 17,689,357	(40%)
Long-term Debt, net	94,520,882	96,013,390	(2%)
Other Long-term Liabilities	4,160,402	4,808,534	(13%)
Total liabilities	<u>\$ 109,377,497</u>	<u>\$ 118,511,281</u>	(8%)
Net Assets:			
Invested in Capital Assets, net of related debt	\$ 142,687,999	\$ 132,138,777	8%
Restricted	3,197,055	2,482,673	29%
Unrestricted	24,461,503	14,494,514	69%
Total net assets	<u>\$ 170,346,557</u>	<u>\$ 149,115,964</u>	14%

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2012

Statements of Revenues, Expenses and Change in Net Assets - Condensed June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>	<u>% Change</u>
Operating Revenues	\$ 22,521,775	\$ 20,799,073	8%
Operating Expenses	<u>20,363,077</u>	<u>17,662,704</u>	15%
Income from operations	<u>2,158,698</u>	<u>3,136,369</u>	(31%)
Non Operating Expenses	(2,991,510)	(3,552,691)	(16%)
Capital Contributions	<u>22,063,405</u>	<u>4,079,487</u>	441%
Increase in net assets	<u>\$ 21,230,593</u>	<u>\$ 3,663,165</u>	479%

The Department's financial condition remains positive at the year-end. As described earlier, net assets is the reported difference between assets and liabilities and which over time, may serve as a useful indicator of the Department's overall financial position. The total assets at year-end for the Department was \$279.7 million and exceeded liabilities by \$170.3 million (net assets). Total net assets increased by \$21.2 million, or 14%, for FY 2012.

Total cash and investments (including restricted funds) decreased by \$15.7 million from \$75.5 million in FY 2011 to \$59.8 million in FY 2012. The decrease is comprised of a \$2.7 million increase in unrestricted cash and investments and a \$18.4 million decrease in restricted cash and investments. The decrease in restricted cash and investments was primarily related to capital expenditures in FY 2012.

The Department's liquidity ratio is (current assets divided by current liabilities) 2.2 for FY 2012 and 1.3 for FY 2011.

The Department finances part of its capital improvement and rehabilitation program through long-term bond issues and State Revolving Fund loans. The debt to equity ratio, including capital leases, for FY 2012 and FY 2011 was 59% and 69%, respectively. The debt service coverage, including capital leases, for FY 2012 is 1.7 which is above the Department's debt service coverage target of 1.5.

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2012

The increase in net assets for FY 2012 amounted to \$21.2 million and is basically a result of the current year's operations and capital contributions. Key elements of this increase are as follows:

Operating revenues for FY 2012 amounted to \$22.5 million, which was \$1.7 million or 8% higher than FY 2011. The increase is basically attributable to the water rate increase in effect as of January 1, 2012.

Total operating expenses increased from \$17.7 million in FY 2011 to \$20.4 million in FY 2012, an increase of \$2.7 million or 15%. The major components of the overall increase are due to the following:

Depreciation expense increased by \$0.4 million and is attributable to capitalized assets added to property, plant and equipment last year.

Power and pumping expense increased by \$0.6 million and is primarily due to the increase in cost for power purchased.

Transmission and distribution expense increased by \$0.5 million and is attributable to expenses related to capital jobs that were closed and expensed.

Administrative and general expense increased by \$0.9 million and is due to the following: workers comp \$0.3 million, contra county expenditure of \$0.2 million, new contracts awarded of \$0.1 million, \$0.23 million increase in inventory variance, and \$0.09 million increase in salaries and wages.

Capital contributions, which are included as non-operating income amounted to \$22.1 million for FY 2012, an increase of 441% from last year's \$4.1 million capital contribution amount.

Department of Water, County of Kauai

Management's Discussion and Analysis
June 30, 2012

Capital Assets and Debt Administration

Capital assets are made up of property, plant and equipment. As of June 30, 2012, the Department had net capital assets of \$211.4 million. Utility plant additions completed in FY 2012 amounted to \$40.1 million. Major capital asset additions included:

Kukuiula - Piwai Wells 16" Transmission Lines	\$1.4 million
Kukuiula - Paanau #2 0.5 MG Tank	\$1.9 million
Vivian Heights/Kanaele Road, Phase II Pipeline Replacement	\$2.6 million
Eiwa, Umi, Akahi & Hardy St/Alohi, Uiki & Lalei Place 8" Main Replacement	\$3.0 million
Omao .5 MG Storage Tank	\$3.1 million
Phase I Waterline (D-1) along Kaehulua Road & Kapaa Hmstds, Phase II Pipeline Replacement	\$3.2 million
Kukuiula - Piwai Wells 2 & 3	\$4.3 million
Kukuiula - Manuhonuhonu Tanks	\$5.4 million
Kaumualii Hwy Widening, Vicinity of Anonui Street to Lihue Mill Bridge	\$9.4 million

Long-term debt obligations outstanding as of June 30, 2012 amounted to \$96.5 million and consisted of \$71.2 million in public improvement bonds and \$25.3 million in State Revolving Fund (SRF) loans. As noted earlier, long-term debt decreased by \$1.6 million, or 1%. This decrease is a result of principal payments made during the year with just minimal additional borrowing through State Revolving Fund loan agreements with the State of Hawaii Department of Health. The Department issued through the County of Kauai \$5.1 million in general obligation bonds for the purpose of refunding the outstanding 2001A Series bonds. More detailed information about the Department's long-term debt is provided in Note 6 of the notes to the basic financial statements.

Department of Water, County of Kauai

Statements of Net Assets

June 30, 2012 and 2011

	<u>Assets</u>	
	<u>2012</u>	<u>2011</u>
Current Assets:		
Cash	\$ 13,105,838	\$ 11,814,067
Equity interest in pooled investments	4,518,770	5,318,020
Receivables:		
Accounts, net of allowance for doubtful accounts of approximately \$303,000 and \$338,000, respectively	2,713,770	2,175,501
Unbilled accounts	1,522,451	1,081,910
Due from State of Hawaii	-	1,431,562
Receivable from primary government	9,226	-
Grants and subsidies	425,161	420,784
Accrued interest	7,653	12,003
Total receivables	<u>4,678,261</u>	<u>5,121,760</u>
Materials and supplies	848,159	872,988
Prepaid expenses	260,511	124,764
Total current assets	<u>23,411,539</u>	<u>23,251,599</u>
Restricted Assets:		
Facility reserve charge funds:		
Cash	2,483,487	1,973,650
Equity interest in pooled investments	2,451,703	2,460,531
Accrued interest receivable	6,389	6,580
Total facility reserve charge funds	<u>4,941,579</u>	<u>4,440,761</u>
Bond funds:		
Cash	1,037,406	533,186
Equity interest in pooled investments	31,023,942	49,583,999
Total bond funds	<u>32,061,348</u>	<u>50,117,185</u>
Total restricted assets	<u>37,002,927</u>	<u>54,557,946</u>
Equity Interest in Pooled Investments - Noncurrent	5,209,187	3,854,697
Accrued Interest - Noncurrent	2,084,422	383,084
Other Assets	<u>579,772</u>	<u>616,937</u>
Utility Plant:		
In service	282,650,130	244,193,482
Accumulated depreciation	(87,055,306)	(81,767,293)
Total utility plant	<u>195,594,824</u>	<u>162,426,189</u>
Construction work in progress	<u>15,841,383</u>	<u>22,536,793</u>
Total property, plant and equipment	<u>211,436,207</u>	<u>184,962,982</u>
Total assets	<u>\$279,724,054</u>	<u>\$267,627,245</u>

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Statements of Net Assets (continued)

June 30, 2012 and 2011

	<u>Liabilities and Net Assets</u>	
	<u>2012</u>	<u>2011</u>
Current Liabilities:		
Current portion of long-term debt	\$ 1,951,000	\$ 2,077,000
Current portion of capital lease obligation	545,000	513,000
Accounts payable and accrued liabilities	4,118,047	3,868,492
Contracts payable, including retainages	1,847,491	8,585,157
Customer advances for construction	657,195	971,140
Accrued vacation and compensatory pay	487,000	555,000
Customer deposits	242,429	269,292
Due to primary government	-	4,317
Post-retirement health care benefits payable	848,051	845,959
Total current liabilities	<u>10,696,213</u>	<u>17,689,357</u>
Restricted Liability--		
Facility Reserve Charge Funds--		
Contracts Payable, including retainages	-	152,535
Long-Term Debt, Net of Current Portion, Unamortized		
Premiums and Deferred Refunding Costs	94,520,882	96,013,390
Capital Lease Obligation, Net of Current Portion	3,792,674	4,338,000
Accrued Vacation and Compensatory Pay, Net of Current Portion	<u>367,728</u>	<u>317,999</u>
Total liabilities	<u>109,377,497</u>	<u>118,511,281</u>
Commitments and Contingencies		
Net Assets:		
Invested in capital assets, net of related debt	142,687,999	132,138,777
Restricted for capital activity and debt service	3,197,055	2,482,673
Unrestricted	<u>24,461,503</u>	<u>14,494,514</u>
Total net assets	<u>\$ 170,346,557</u>	<u>\$ 149,115,964</u>

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Statements of Revenues, Expenses and Changes in Net Assets
For the Years Ended June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Operating Revenues:		
Water sales	\$ 21,283,377	\$ 19,829,485
Other water revenue:		
Public fire protection service	1,147,741	943,901
Other	<u>90,657</u>	<u>25,687</u>
Total operating revenues	<u>22,521,775</u>	<u>20,799,073</u>
Operating Expenses:		
Depreciation	6,163,290	5,743,108
Administrative and general	5,115,101	4,164,793
Power and pumping	4,015,455	3,323,041
Transmission and distribution	3,501,544	3,017,417
Source of supply	787,402	623,721
Customer accounting and collection	605,480	591,277
Purification	<u>174,805</u>	<u>199,347</u>
Total operating expenses	<u>20,363,077</u>	<u>17,662,704</u>
Income from operations	<u>2,158,698</u>	<u>3,136,369</u>
Non-Operating Income (expense):		
Investment income	1,878,897	758,722
Interest expense, net of amounts capitalized	(4,083,069)	(4,311,413)
Loss on disposal of assets	<u>(787,338)</u>	<u>-</u>
Total non-operating expenses	<u>(2,991,510)</u>	<u>(3,552,691)</u>
Loss before contributions	(832,812)	(416,322)
Capital contributions	<u>22,063,405</u>	<u>4,079,487</u>
Change in net assets	21,230,593	3,663,165
Net Assets at Beginning of Year	<u>149,115,964</u>	<u>145,452,799</u>
Net Assets at End of Year	<u><u>\$ 170,346,557</u></u>	<u><u>\$ 149,115,964</u></u>

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Statements of Cash Flows

For the Years Ended June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Cash Flows from Operating Activities:		
Cash received from customers	\$ 20,295,341	\$ 19,053,315
Cash payments to suppliers for goods and services	(9,583,011)	(7,733,356)
Cash payments to employees for services	(4,367,959)	(4,189,640)
Other cash receipts	<u>1,238,398</u>	<u>969,588</u>
Net cash provided by operating activities	<u>7,582,769</u>	<u>8,099,907</u>
Cash Flows from Capital and Related Financing Activities:		
Proceeds from issuance of public improvement bonds	5,440,298	-
Acquisition and construction of capital assets	(18,615,589)	(12,260,281)
Proceeds from revolving fund loan	204,867	3,571,323
Principal paid on revolving fund loan	(1,586,203)	(1,348,253)
Payments for bond issuance costs	(59,345)	-
Principal paid on public improvement bond maturities	(425,500)	(469,500)
Principal paid on capital lease obligation	(513,331)	(482,830)
Cash paid for defeasance of public improvement bond	(5,240,000)	-
Interest paid on long-term debt	(5,711,673)	(4,898,748)
Proceeds from state government capital grants	1,427,482	-
Proceeds from BAB Subsidy	1,022,308	871,802
Net proceeds (refunds) from FRC Program	<u>584,000</u>	<u>(375,600)</u>
Net cash used in capital and related financing activities	<u>(23,472,686)</u>	<u>(15,392,087)</u>
Cash Flows from Investing Activities:		
Purchases of investments	(422,694,579)	(610,616,578)
Sales and maturities of investments	440,800,200	621,313,092
Interest on investments	<u>90,124</u>	<u>123,940</u>
Net cash provided by investing activities	<u>18,195,745</u>	<u>10,820,454</u>
Net increase in cash (including restricted cash)	2,305,828	3,528,274
Cash (including restricted cash), Beginning of Year	<u>14,320,903</u>	<u>10,792,629</u>
Cash (including \$3,520,893 and \$2,506,836 in restricted cash, respectively), End of Year	<u><u>\$ 16,626,731</u></u>	<u><u>\$ 14,320,903</u></u>

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Statements of Cash Flows (continued)
For the Years Ended June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Reconciliation of Cash Flows from Operating Activities:		
Income from operations	\$ 2,158,698	\$ 3,136,369
Depreciation expense	6,163,290	5,743,108
Bad debt expense	24,561	132,327
(Increase) decrease in assets:		
Accounts receivable, net	(562,830)	(1,153,825)
Unbilled accounts and other receivables	(449,767)	245,328
Materials and supplies	24,829	74,873
Prepaid expenses and other assets	(39,237)	55,444
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	310,584	(569,310)
Accrued vacation and compensatory pay	(18,271)	(101,412)
Other liabilities, restricted	-	(226,106)
Post-retirement healthcare benefits payable	2,092	845,959
Due to primary government	(4,317)	20
Customer deposits	(26,863)	(82,868)
Net cash provided by operating activities	<u>\$ 7,582,769</u>	<u>\$ 8,099,907</u>

Supplemental Disclosure of Non-cash Capital and Related Financing Activities:

The Department received approximately \$20,453,000 and \$2,003,000 for the years ended June 30, 2012 and 2011, respectively, in contributions of property, plant and equipment from governmental agencies, developers and customers which are recorded as contributions at estimated fair value at the date of donation.

See accompanying notes to basic financial statements.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

1. Background

On May 10, 1960, by authority of Act 20, Session Laws of Hawaii 1960, the Board of Water Supply (the Board) of the County of Kauai, Hawaii (the County) was created. The County transferred to the Board the operation and management of the water transmission and distribution systems. Under Act 20, the Board has the power to make and alter rules and regulations relating to the management, control, operation, preservation and protection of the waterworks. The rules and regulations adopted by the Board have the force and effect of law.

As of January 2, 1969, under a new charter for the County, the policy-making responsibility for the water system was retained by the Board. The Board, however, is specifically stated to be an executive department of the County government. To the extent that they were not in conflict with the provisions of the charter, laws governing the County water supply which were in existence at the time of the enactment of the charter continued in effect. The water system is now being operated as the Department of Water, County of Kauai (the Department), a self-supporting component unit (enterprise fund) of the County which renders water services throughout the island.

The Department is responsible for establishing rates for services based upon current operating costs and expected future capital and operating revenue requirements. The rates determined by the Department are subject to approval by the Board. Effective January 1, 2012, the Board raised rates an average 26 percent and decreased the service charge rate an average of 49 percent. Effective July 1, 2010, the Board also raised the service charge rate an average of 118 percent.

2. Summary of Significant Accounting Policies

a. Financial Statement Presentation

The Department is a component unit of the County (the primary government). The accompanying financial statements present only the activities of the Department and do not include other organizations, activities and functions of the County.

b. Basis of Accounting

The accompanying financial statements are presented using the economic resources measurement focus and the accrual basis of accounting, whereby revenues and expenses are recognized in the period earned or incurred.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

2. Summary of Significant Accounting Policies (continued)

b. Basis of Accounting (continued)

The Department distinguishes operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services in connection with the Department's principal ongoing water operations. The principal operating revenues are from charges for water usage, while operating expenses include cost of services, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

The Department follows Governmental Accounting Standards Board (GASB) Statement No. 20, "Accounting and Financial Reporting for Proprietary Fund Accounting." Under GASB No. 20, the Department applies all applicable Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board Opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Department does not apply FASB Statements and Interpretations issued after November 30, 1989.

c. Cash

The Department's cash include cash on hand, demand deposits and short-term investments with original maturities of three months or less from the date of acquisition.

d. Investments

The Department has stated its investments at fair value. Changes in the fair value of investments are recognized in the statements of revenues, expenses and changes in net assets.

e. Management Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include revenue recognized related to unbilled accounts, accrued liability for workers' compensation claims and judgments and accrued liability for post-retirement health care benefits. Actual results could differ from those estimates.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

2. Summary of Significant Accounting Policies (continued)

f. Utility Plant in Service (UPIS) and Depreciation

In July 1966, a detailed report on the inventory and valuation of water utility properties of the Board was submitted by R. W. Beck and Associates, Analytical and Consulting Engineers, of Seattle, Washington. The estimated original cost of \$5.8 million and the reserve for depreciation of \$1.4 million were recorded in the accounts. Additions to the utility plant since the date of the valuation are stated at cost and include contributions by government agencies, private developers and customers at their fair value at the date of contribution.

Depreciation on the utility plant is computed over the estimated useful lives of the various individual and group assets using the straight-line method. Depreciation expense for the year is calculated using plant balances, including contributions in aid of construction, at the beginning of the year.

The estimated useful lives of the various individual and group assets are as follows:

Motor vehicles	7 to 10 years
Equipment and machinery	5 to 20 years
Buildings and improvements	40 to 50 years
Transmission and distribution equipment	18 to 63 years

Normal maintenance and repairs are charged to operations as incurred. All expenditures for major additions, betterments and replacements for the utility plant are capitalized, and expenditures for the general plant greater than \$1,000 are capitalized. The Department capitalizes certain indirect costs to construction work orders based upon actual construction direct labor hours.

As of June 30, 2012 and 2011, included in utility plant in service is utility plant held for future use with a carrying value of approximately \$975,000 and \$1,006,000, respectively, related to a water tunnel. The Department is currently assessing whether further modifications will be made to bring the asset into compliance with the Environmental Protection Agency's regulations. In 2012 and 2011, no impairment losses were identified by the Department.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

2. Summary of Significant Accounting Policies (continued)

g. Capitalization of Interest

Interest costs have been capitalized, in accordance with Accounting Standards Codification No. 830, "Capitalization of Interest Cost," based on an average of expended costs through the end of the year. Capitalized interest in 2012 and 2011 was approximately \$533,000 and \$409,000, respectively.

h. Material and Supplies

Materials and supplies are stated at lower of average cost (which approximates the first-in, first-out method) or market.

i. Revenue Recognition

The Department recognizes revenue on the accrual method of accounting as services are rendered. Revenue recognized for services rendered but not billed is reflected as unbilled accounts in the accompanying statements of net assets.

j. Risk Management

The Department is exposed to various risks of loss from: (1) torts, (2) theft of, damage to and destruction of assets, (3) employee injuries and illnesses, (4) natural disasters, (5) employee health, dental and accident benefits, and (6) miscellaneous others. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims in excess of this commercial coverage was not significant in any of the three preceding years. The Department is self-insured for workers' compensation claims and judgments.

k. Capital Contributions

The following transactions represent voluntary non-exchange transactions and are recorded at fair value and are included as non-operating income in the statements of revenues, expenses and changes in net assets:

- Receipts from federal and state financial assistance restricted to the acquisition of fixed assets
- Contributed utility plant in service
- Receipts of facility reserve charges
- Interest subsidies related to certain bonds (see Note 6)

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

2. Summary of Significant Accounting Policies (continued)

k. Capital Contributions (continued)

At June 30, 2012 and 2011, the Department recorded approximately \$421,000, of accrued interest subsidies in grants and subsidies receivable in the accompanying statements of net assets.

l. Facilities Reserve Charge (FRC)

Under the authority provided to the Board mentioned in Note 1, the Department assesses a fee to commercial and residential developers based upon the number and size of water meters installed at respective projects. These fees are restricted to fund the capital improvements of the water supply system and recorded as contributions in the statements of revenues, expenses and changes in net assets.

m. Net Assets

Net assets comprise the various net earnings from operating and non-operating revenues, expenses and contributions in aid of construction. Net assets are classified in the following three components: invested in capital assets, net of related debt; restricted for capital activity and debt service; and unrestricted net assets. Invested in capital assets, net of related debt, consist of capital assets, net of accumulated depreciation and reduced by outstanding debt that is attributable to the acquisition, construction or improvement of those assets. Debt related to unspent proceeds or other restricted cash and investments at year-end are not included in the calculation of invested in capital assets, net of related debt. Restricted for capital activity and debt service consists of net assets for which constraints are placed thereon by external parties, such as lenders, grantors, contributors, laws, regulations and enabling legislation, including self-imposed legal mandates. Unrestricted consists of all other net assets not included in the above categories.

n. Reclassifications

Certain 2011 balances have been reclassified to be consistent with the current year presentation. Such reclassifications had no effect on the previously reported results of operations.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

3. Deposits

The Department's deposits consist of cash, money market accounts and non-negotiable certificates of deposits. The Department's deposits are controlled by the Director of Finance of the County of Kauai.

At June 30, 2012 and 2011, the carrying value of the Department's cash deposits amount to approximately \$16,627,000 and \$14,321,000, respectively, of which approximately \$5,665,000 and \$4,397,000, respectively, were held by the County in the County's name. The banks' balances at June 30, 2012 and 2011 amounted to approximately \$16,458,000 and \$13,640,000, respectively. The Director of Finance has arranged for all of the Department's deposits at June 30, 2012 and 2011 to be collateralized with securities held by the pledging financial institution in the County's name.

4. Investments

The Department's investments are controlled by the Director of Finance of the County of Kauai and are generally invested in certificates of deposit, repurchase agreements, government sponsored entity securities (i.e., Federal Home Loan Bank notes and bonds, Federal Home Loan Mortgage Corporation bonds, and Federal National Mortgage Association notes and bonds) with federally insured financial institutions and mutual funds. The Department's investment vehicles are consistent with the investment guidelines contained in the Hawaii Revised Statutes (HRS).

The Department participates in an investment pool with the County. The Department's portion of this pool is displayed on the statements of net assets as equity interest in pooled investments.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

4. Investments (continued)

The following is the composition of the Department's portion of these investments as of June 30, 2012 and 2011:

2012:	Fair Value (approximate)	Maturity (in years)	
		0-1	1-5
Government sponsored entities and other agencies	\$ 34,237,000	\$ 29,227,000	\$ 5,010,000
US governments	3,314,000	2,281,000	1,033,000
Other fixed income	2,020,000	2,020,000	-
Money market funds	1,982,000	1,982,000	-
US corporates	102,000	-	102,000
Total	<u>\$ 41,655,000</u>	<u>\$ 35,510,000</u>	<u>\$ 6,145,000</u>

2011:	Fair Value (approximate)	Maturity (in years)	
		0-1	1-5
Government sponsored entities and other agencies	\$ 42,861,000	\$ 5,498,000	\$ 37,363,000
US governments	8,956,000	-	8,956,000
Money market funds	6,256,000	1,000,000	5,256,000
Other fixed income	480,000	480,000	-
US corporates	105,000	-	105,000
Total	<u>\$ 58,658,000</u>	<u>\$ 6,978,000</u>	<u>\$ 51,680,000</u>

As of June 30, 2012 and 2011, excluded from the above disclosures is approximately \$1,549,000 and \$2,559,000, respectively, of non-negotiable certificates of deposit which are classified as equity interest in pooled investments in the statements of net assets, but are considered deposits for the purposes of this disclosure.

Interest Rate Risk – State law limits the Department's investment portfolio to maturities of less than five years. The Department does not have a formal investment policy that further limits investment maturities.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

4. Investments (continued)

Credit Risk – State law limits investments to the top rating issued by nationally recognized statistical rating organizations (NRSROs). The Department has no investment policy that would further limit its investment choices. As of June 30, 2012, with the exception of the Department's investment in certain fixed income and mutual funds which was not rated, all of the Department's investments were rated Baa-AA.

Custodial Credit Risk – For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Department will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party.

Concentration of Credit Risk – The Department places no limit on the amount which may be invested in any one issuer. As of June 30, 2012, more than 5 percent of the Department's investments are held in the following: Fannie Mae (30%), Federal Home Loan Bank (24%), Federal Farm Credit Bank (15%) and US Treasury (8%).

5. Property, Plant and Equipment

Property, plant and equipment activity during 2012 was as follows:

	Balance June 30, 2011	Additions	Reductions/ Transfers	Balance June 30, 2012
Utility Plant in Service	\$ 244,193,482	\$ 40,119,263	\$ (1,662,615)	\$ 282,650,130
Accumulated Depreciation	(81,767,293)	(6,950,628)	1,662,615	(87,055,306)
	<u>162,426,189</u>	<u>33,168,635</u>	<u>-</u>	<u>195,594,824</u>
Construction in Progress	22,536,793	14,723,038	(21,418,448)	15,841,383
Total	<u>\$ 184,962,982</u>	<u>\$ 47,891,673</u>	<u>\$(21,418,448)</u>	<u>\$ 211,436,207</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

5. Property, Plant and Equipment (continued)

Property, plant and equipment activity during 2011 was as follows:

	Balance June 30, 2010	Additions	Reductions/ Transfers	Balance June 30, 2011
Utility Plant in Service	\$ 223,914,069	\$ 20,531,337	\$ (251,924)	\$ 244,193,482
Accumulated Depreciation	(76,276,107)	(5,743,110)	251,924	(81,767,293)
	<u>147,637,962</u>	<u>14,788,227</u>	<u>-</u>	<u>162,426,189</u>
Construction in Progress	19,006,515	23,805,075	(20,274,797)	22,536,793
Total	<u>\$ 166,644,477</u>	<u>\$ 38,593,302</u>	<u>\$(20,274,797)</u>	<u>\$ 184,962,982</u>

6. Long-Term Liabilities

Bonds Payable

The full faith and credit of the County is pledged for the payment of the Department's obligations. The County has the power and is obligated to levy ad valorem taxes, without limitation as to rate or amount, on all real property subject to taxation by the County.

Unamortized bond issuance cost was approximately \$572,000 and \$595,000 at June 30, 2012 and 2011, respectively. This cost is amortized over the term of the respective bond and is included as other assets in the accompanying statements of net assets.

On July 7, 2011, the Department issued through the County \$5,125,000 in general obligation bonds, with a premium of approximately \$315,000 and an average interest rate of 3.75 percent, for the purpose of refunding \$5,240,000 of outstanding 2001A Serial bonds, with an average rate of 5.37 percent. The net proceeds of the issuance was \$5,380,953 after payment of \$59,345 in underwriting fees and other issuance costs. The net proceeds were transferred to an escrow deposit account to redeem the outstanding 2001A Series bonds.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

6. Long-Term Liabilities (continued)

Bonds Payable (continued)

The current refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of approximately \$169,000. The amount is being netted against the new debt and amortized over the new debt's life. The Department completed the current refunding to reduce its total debt service payments over the next 14 years by approximately \$1,067,000 and to obtain an economic gain (difference between the present values of the old and new debt service payments) of approximately \$812,000.

As of June 30, 2012 and 2011, bonds payable consisted of the following:

	2012	2011
Public Improvement Bonds--County Series 2011A, last installment 2025. Maturing serially from August 1, 2011. Interest rate - 4.50 to 5.63 percent. Date issued - July 7, 2011. Original amount - \$5,125,000.	\$ 4,780,000	\$ -
Build America Bonds--County Series 2010A, last installment 2033. Maturing serially from August 1, 2013. Interest rate - 1.96 to 5.76 percent. Date issued - March 24, 2010. Original amount - \$60,000,000.	60,000,000	60,000,000
Public Improvement Bonds--County Series 2005A, last installment 2021. Maturing serially from August 1, 2008. Interest rate - 3.25 to 5.00 percent. Date issued - November 10, 2005. Original amount - \$6,485,000.	6,240,000	6,305,000
Public Improvement Bonds--County Series 2001A, last installment 2025. Maturing serially from August 1, 2001. Interest rate - 4.0 to 6.25 percent. Date issued - May 15, 2001. Original amount - \$11,725,000.	-	5,240,000
Public Improvement Bonds--County Series 1980, last installment 2015. Maturing serially from March 1, 1983. Interest rate - 5 percent. Date issued - April 7, 1980. Original amount - \$300,000.	51,000	66,500
Total bonds payable	71,071,000	71,611,500
Premium on bond issuance and deferred refunding costs	140,584	(162,744)
Total bonds payable, net	\$ 71,211,584	\$ 71,448,756

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

6. Long-Term Liabilities (continued)

Bonds Payable (continued)

The approximate annual debt service requirements through 2017 and in five-year increments thereafter to maturity as of June 30, 2012 are as follows:

Years ending	Principal	Interest	Total
June 30:			
2013	\$ 356,000	\$ 3,386,000	\$ 3,742,000
2014	2,237,000	3,357,000	5,594,000
2015	2,683,000	3,293,000	5,976,000
2016	2,745,000	3,211,000	5,956,000
2017	2,840,000	3,117,000	5,957,000
2018-2022	16,020,000	13,733,000	29,753,000
2023-2027	17,065,000	9,895,000	26,960,000
2028-2032	19,665,000	5,010,000	24,675,000
2033-2034	7,460,000	387,000	7,847,000
	<u>\$ 71,071,000</u>	<u>\$ 45,389,000</u>	<u>\$ 116,460,000</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

6. Long-Term Liabilities (continued)

Loans Payable

As of June 30, 2012 and 2011, the loans payable consisted of the following:

	2012	2011
State Revolving Fund (SRF) Loan – Stable 1.0 MG Tank, last installment 2029. Interest rate – .130 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – March 15, 2009. Original amount \$7,274,996.	\$ 6,498,004	\$ 6,872,043
SRF Loan – Poipu Road 16 Inch Main Replacement, last installment 2027. Interest rate – .160 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – January 15, 2007. Original amount - \$5,595,979.	3,989,775	4,252,385
SRF Loan – Kaunualii Highway 12 Inch Main Replacement, last installment 2029. Interest rate – .160 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – August 15, 2009. Original amount - \$3,989,537.	3,602,184	3,802,136
SRF Loan – Kapilimao 0.5 MG Tank, last installment 2030. Interest rate – .210 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – January 15, 2010. Original amount - \$3,793,779.	3,570,629	3,547,585
SRF Loan – 16 Inch Waterline Replacement along Kuhio Highway, Leho Drive to North Papaloa Road, last installment 2026. Interest rate – .160 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – August 15, 2005. Original amount - \$2,481,289.	1,706,073	1,826,487
SRF Loan – Waha, Wawae & Niho Roads Main Replacement, last installment 2029. Interest rate – .160 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – August 15, 2009. Original amount - \$1,844,718.	1,660,876	1,753,002
SRF Loan – Damage Repairs to Kokolau Tunnel, last installment 2021. Interest rate – 1.37 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – July 15, 2001. Original amount - \$1,755,329.	868,942	954,019
SRF Loan – Rehabilitate Lihue Steel Tanks 1 & 2, last installment 2024. Interest rate – .46 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – January 15, 2004. Original amount - \$1,243,017.	868,641	933,308
SRF Loan – Replace Pipeline at Hanapepe River Crossing and Control of Slope; Failure at Hanapepe Well No. 3, last installment 2023. Interest rate – .99 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – July 15, 2003. Original amount - \$1,345,040.	762,027	824,293

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

6. Long-Term Liabilities (continued)

Loans Payable (continued)

	<u>2012</u>	<u>2011</u>
SRF Loan – Ornellas 0.2 MG Tank, last installment 2025. Interest rate – .58 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – January 15, 2005. Original amount - \$809,398.	\$ 558,285	\$ 599,514
SRF Loan – Kekaha Well, last installment 2022. Interest rate – 1.01 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – April 15, 2002. Original amount - \$1,097,536.	493,169	539,795
SRF Loan – Rehabilitation of 27 Inch Steel Pipeline – Hanapepe - Eleele Water System, last installment 2023. Interest rate – .99 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – July 15, 2003. Original amount - \$691,134.	424,704	459,404
SRF Loan – Wailua Homesteads Well No. 3, last installment 2024. Interest rate – .54 percent. Semi-annual loan fee rate – 1.625 percent. Date issued – March 15, 2004. Original amount - \$418,967.	256,989	277,663
	<u>\$ 25,260,298</u>	<u>\$ 26,641,634</u>

The approximate annual debt service requirements through 2017 and in five-year increments thereafter to maturity as of June 30, 2012 are as follows:

Years ending June 30:	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2013	\$ 1,595,000	\$ 898,000	\$ 2,493,000
2014	1,608,000	843,000	2,451,000
2015	1,614,000	784,000	2,398,000
2016	1,621,000	725,000	2,346,000
2017	1,628,000	665,000	2,293,000
2018-2022	8,192,000	2,424,000	10,616,000
2023-2027	6,838,000	1,021,000	7,859,000
2028-2030	2,164,000	157,000	2,321,000
	<u>\$ 25,260,000</u>	<u>\$ 7,517,000</u>	<u>\$ 32,777,000</u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

6. Long-Term Liabilities (continued)

Capital Lease Obligation

On February 19, 2004, the Department entered into a Water Treatment and Delivery Agreement (Agreement) with an unrelated third party developer. The Agreement requires the developer to build, operate and maintain a surface water treatment plant (SWTP) with a capacity of 3.0 million gallons per day (MGD). The Department is required to purchase, at a minimum, 2.0 MGD and also to provide the developer a credit towards its facility reserve charge. The term of the Agreement is 15 years and the Agreement also provides the Department with the option of accepting the dedication of the SWTP at no cost after the reimbursement date, as defined. The Department commenced water purchases on January 1, 2006. This arrangement has been recorded as a capital lease in the accompanying basic financial statements.

The capital lease obligation is amortized at an implicit rate of approximately 6.0 percent. The annual requirements to amortize capital lease obligation as of June 30, 2012 are approximately as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Years ending June 30:			
2013	\$ 545,000	\$ 247,000	\$ 792,000
2014	579,000	213,000	792,000
2015	615,000	177,000	792,000
2016	653,000	139,000	792,000
2017	693,000	99,000	792,000
2018-2019	1,253,000	67,000	1,320,000
	<u>\$ 4,338,000</u>	<u>\$ 942,000</u>	<u>\$ 5,280,000</u>

The utility plant related to the SWTP facility approximated \$7,181,000 as of June 30, 2012 and 2011. The accumulated provision for depreciation related to the SWTP facility approximated \$3,475,000 and \$2,943,000 as of June 30, 2012 and 2011, respectively.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

6. Long-Term Liabilities (continued)

Changes in long-term liabilities

Long-term liability activity for the years ended June 30, 2012 and 2011 was as follows:

	Balance June 30, 2011	Additions	Reductions	Balance June 30, 2012	Approximate amounts due within one year
Bonds payable:					
General obligation bonds	\$ 71,611,500	\$ 5,125,000	\$ 5,665,500	\$ 71,071,000	\$ 356,000
Deferred costs:					
For premiums on bond issuance	221,622	315,298	105,138	431,782	-
On refunding	(384,366)	(14,572)	(107,740)	(291,198)	-
	(162,744)	146,643	(156,685)	140,584	-
Total bonds payable	71,448,756	5,425,726	5,662,898	71,211,584	356,000
Loans payable	26,641,634	204,867	1,586,203	25,260,298	1,595,000
Total long term debt	98,090,390	5,630,593	7,249,101	96,471,882	1,951,000
Compensated absences	872,999	513,389	531,660	854,728	487,000
Capital lease obligation	4,851,000	-	513,326	4,337,674	545,000
Total	\$103,814,389	\$ 6,143,982	\$ 8,294,087	\$ 101,664,284	\$ 2,983,000
	Balance June 30, 2010	Additions	Reductions	Balance June 30, 2011	Approximate amounts due within one year
Bonds payable:					
General obligation bonds	\$ 72,081,000	\$ -	\$ 469,500	\$ 71,611,500	\$ 491,000
Deferred costs:					
For premiums on bond issuance	235,229	-	13,607	221,622	-
On refunding	(386,243)	-	(1,877)	(384,366)	-
	(151,014)	-	11,730	(162,744)	-
Total bonds payable	71,929,986	-	481,230	71,448,756	491,000
Loans payable	24,418,564	3,571,323	1,348,253	26,641,634	1,586,000
Total long term debt	96,348,550	3,571,323	1,829,483	98,090,390	2,077,000
Compensated absences	974,411	488,412	589,824	872,999	555,000
Capital lease obligation	5,333,830	-	482,830	4,851,000	513,000
Total	\$102,656,791	\$ 4,059,735	\$ 2,902,137	\$ 103,814,389	\$ 3,145,000

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

7. Net Assets

At June 30, 2012 and 2011, net assets consisted of the following:

	2012	2011
Invested in Capital Assets, Net of Related Debt:		
Net property, plant and equipment	\$ 211,436,207	\$ 184,962,982
Less: Long term debt, net	(96,471,882)	(98,090,390)
Less: Capital lease obligation	(4,377,674)	(4,851,000)
Add: Unspent debt proceeds	32,061,348	50,117,185
	<u>142,687,999</u>	<u>132,138,777</u>
Restricted for Capital Activity and Debt Service:		
FRC net assets	4,941,579	4,288,226
Restricted cash – Bond funds	1,037,406	533,186
Restricted investments – Bond funds	31,023,942	49,583,999
Less:		
Accrued interest payable	(1,744,524)	(1,805,553)
Unspent debt proceeds	(32,061,348)	(50,117,185)
	<u>3,197,055</u>	<u>2,482,673</u>
Unrestricted	<u>24,461,503</u>	<u>14,553,030</u>
Total net assets	<u><u>\$ 170,346,557</u></u>	<u><u>\$ 149,115,964</u></u>

As of June 30, 2012 and 2011, FRC net assets consisted of the following:

	2012	2011
FRC assets restricted for utility plant construction:		
Cash	\$ 2,483,487	\$ 1,973,650
Equity interest in pooled investments	2,451,703	2,460,531
Accrued interest receivable	6,389	6,580
	<u>4,941,579</u>	<u>4,440,761</u>
FRC liabilities	<u>-</u>	<u>(152,535)</u>
FRC net assets	<u><u>\$ 4,941,579</u></u>	<u><u>\$ 4,288,226</u></u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

7. Net Assets (continued)

At June 30, 2012, the Department had approximately \$1.7 million in FRC costs that were paid with unrestricted funds (Water Utility) that will be transferred from the FRC subsequent to year end. The respective amounts due to Water Utility and due from FRC have been eliminated on the accompanying statement of net assets and were not reflected in FRC restricted net assets as of June 30, 2012.

Net FRC additions (refunds) amounted to approximately \$584,000 and \$(376,000) for the years ended June 30, 2012 and 2011, respectively, and are included in capital contributions on the accompanying statements of revenues, expenses and changes in net assets.

8. Employees' Retirement System

a. Description of Plan

All eligible employees of the State and counties are required by Hawaii Revised Statutes (HRS) Chapter 88, to become members of the Employees' Retirement System of the State of Hawaii (ERS), a cost-sharing multiple-employer public employee retirement plan. The ERS is governed by a Board of Trustees. All contributions, benefits and eligibility requirements are established by HRS Chapter 88 and can be amended by legislative action. The ERS issues a comprehensive annual financial report that is available to the public. That report may be obtained by writing to the ERS at 201 Merchant Street, Suite 1400, Honolulu, Hawaii 96813.

Prior to June 30, 1984, the plan consisted of only a contributory plan. In 1984, legislation was enacted to add a new noncontributory plan for members of the ERS who are also covered under Social Security. Policy officers, firefighters, judges, elected officials, and person employed in positions not covered by Social Security are precluded from the noncontributory plan. The noncontributory plan provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory plan or to elect the new noncontributory plan and receive a refund of employee contributions. All benefits vest after five and ten year credited service under the contributory and noncontributory plans, respectively.

Both plan options provide a monthly retirement allowance based on the employee's age, years of credited service, and average final compensation (AFC). The AFC is the average salary earned during the five highest paid years of service, including the vacation payment, if the employee became a member prior to January 1, 1971. The AFC for members hired on or after that date is based on the three highest paid years of service, excluding the vacation payment.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

8. Employees' Retirement System (continued)

a. Description of Plan (continued)

On July 1, 2006, a new hybrid contributory plan became effective pursuant to Act 179, SLH of 2004. Members in the hybrid plan are eligible for retirement at age 62 with 5 years of credited services or age 55 and 30 years of credit service. Members will receive a benefit multiplier of 2 percent for each year of credited service in the hybrid plan. The benefit payment options are similar to the current contributory plan. Almost 58,000 current members, all members of the noncontributory plan and certain members of the contributory plan are eligible to join the new hybrid plan. Most of the new employees hired from July 1, 2006 are required to join the new hybrid plan.

b. Funding Policy

Most covered employees of the contributory option are required to contribute 7.8 percent of their salary. Police officers, firefighters, investigators of the department of the County Prosecuting Attorney and the Attorney General, narcotics enforcement investigators, and public safety investigators are required to contribute 12.2 percent of their salary. The funding method used to calculate the total employer contribution requirement is the Entry Age Normal Actuarial Cost Method. Effective July 1, 2005, employer contribution rates are a fixed percentage of compensation, including the normal cost plus amounts required to pay for the unfunded actuarial accrued liability.

The ERS provides basic pension benefits to individuals receiving pensions. Employer contributions to the ERS are comprised of normal cost plus level annual payments required to liquidate the unfunded accrued liability of the ERS. The ERS uses the entry age normal cost funding method to calculate the unfunded accrued liability. In 2002, the Legislature of the State of Hawaii approved Act 147 that extends the amortization period to liquidate the unfunded liability from 15 years to 29 years.

The Department's payroll for employees covered by the plan was approximately \$4,285,000, \$4,014,000, and \$4,260,000 for 2012, 2011, and 2010, respectively. The payroll for all of the Department's employees was approximately \$4,368,000, \$4,190,000 and \$4,424,000 for 2012, 2011, and 2010, respectively. The Department is required to contribute an actuarially determined amount to the ERS. The Department's contributions requirements as of June 30, 2012, 2011 and 2010 were approximately \$642,000, \$601,000 and \$639,000, respectively. The contribution rate was 15.00 percent for the years ended June 30, 2012, 2011 and 2010.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

9. Post-Retirement Health Care and Life Insurance Benefits

a. Plan Description

The Department provides certain other postemployment benefits (OPEB) other than pensions to all qualified employees. Pursuant to Chapter 87A of the Hawaii Revised Statutes (HRS), the Department contributes to the Hawaii Employer-Union Health Benefits Trust Fund (EUTF). The EUTF was established to provide a single delivery system of health benefits for state and county workers, retirees and their dependents. The EUTF currently provides medical, dental, vision, and life insurance benefits. The EUTF issues an annual financial report that is available to the public. That report may be obtained by writing to the EUTF at 201 Merchant Street, Suite 1520, Honolulu, Hawaii 96813.

The eligibility requirements for retiree health benefits are as follows:

For employees hired before July 1, 1996, the Department pays the entire monthly health care premium for employees retiring with ten or more years of credited service, and 50% of the monthly premium for employees retiring with fewer than ten years of credited service.

For employees hired after June 30, 1996, and who retire with fewer than 10 years of service, the Department makes no contributions. For those retiring with at least 10 years but fewer than 15 years of service, the Department pays 50% of the retired employees' monthly Medicare or non-Medicare premium. For employees hired after June 30, 1996, and who retire with at least 15 years but fewer than 25 years of service, the Department pays 75% of the retired employees' monthly Medicare or non-Medicare premium; for those retiring with over 25 years of service, the Department pays the entire health care premium.

In November 2011, the Department was notified that the trust fund established by the EUTF to collect the Department's OPEB contributions did not meet the requirements of GASB Statement No. 43. Subsequently, the EUTF drafted legislation to create a qualifying trust in order to treat such payments as contributions, which was signed in to law on July 10, 2012. For the years ended June 30, 2012 and 2011, the Department has recorded all payments to the EUTF for OPEB as contributions in accordance with GASB Statement No. 43.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

9. Post-Retirement Healthcare and Life Insurance Benefits (continued)

b. Funding Policy

For active employees, the employer's contributions are based upon negotiated collective bargaining agreements. Employer contributions for employees not covered by collective bargaining agreements and for retirees are prescribed by the HRS.

The Department is required to contribute the annual required contribution of the employer (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover the normal cost each year and amortize any unfunded actuarial liabilities over 30 years. The current ARC rate for the Department is approximately 25% of annual covered payroll.

c. Annual OPEB Cost

The following table shows the components of the Department's annual OPEB cost for 2012, the amount actually contributed to the plan, and changes in the Department's net OPEB obligation (asset) to EUTF:

Annual required contribution (ARC)	\$ 1,110,000
Interest on net OPEB obligation (asset)	(4,000)
Adjustment to the ARC	<u>3,000</u>
Annual OPEB Cost	1,109,000
Contributions made	<u>(1,089,000)</u>
Decrease in net OPEB asset	20,000
Net OPEB obligation (asset) – beginning of year	<u>(50,000)</u>
Net OPEB obligation (asset) – end of year	<u>\$ (30,000)</u>

For 2011, the Department's annual OPEB cost of approximately \$1,072,000 was equal to ARC.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

9. Post-Retirement Healthcare and Life Insurance Benefits (continued)

c. Annual OPEB Cost (continued)

The Department's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan and the net OPEB obligation for 2012, 2011 and 2010 were approximately as follows:

Fiscal Year Ended June 30,	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation (Asset)
2010	\$ 755,000	100.9%	\$ (7,000)
2011	1,072,000	104.7%	(50,000)
2012	1,109,000	98.2%	(30,000)

At June 30, 2012 and 2011, the Department's post-retirement healthcare payable of \$848,051 and \$845,959, respectively, is considered a short-term difference and has been included in the respective annual OPEB contributions in accordance with GASB Statement No. 45.

d. Funded Status and Funding Progress

The funded status of the plan as of July 1, 2011, the effective date of the biennial actuarial valuation, was as follows:

Actuarial accrued liability (AAL)		\$ 11,586,000
Assets		<u>2,281,000</u>
Unfunded AAL (UAAL)		<u><u>\$ 9,305,000</u></u>
	<u>2012</u>	<u>2011</u>
Covered payroll	\$ 4,368,000	\$ 4,190,000
UAAL as a percentage of covered payroll	213%	301%

Actuarial valuations of an ongoing plan involve estimate of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality and healthcare cost trends. Amounts determined regarding the funded status of the plan and the ARC are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedule of funding progress, presented as required supplementary information following the notes of the financial statements, presents multiyear trend information that shows whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

9. Post-Retirement Healthcare and Life Insurance Benefits (continued)

e. Actuarial Methods and Assumptions

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. Significant methods and assumptions from the Department's actuarial valuation were as follows:

Valuation date	July 1, 2011
Actuarial cost method	Entry age normal
Amortization method	Level percentage of pay, closed
Remaining amortization period	30 years
Actuarial assumptions:	
Investment rate of return	7%
Healthcare cost trend rate:	
Medical and prescription drug	8.5% initial; 5% ultimate
Dental	4% initial; 4% ultimate
Vision	3% initial; 3% ultimate
Medicare Part B	13.43 initial; 5% ultimate
Projected salary increases	3.5%

The number of participants as of July 1, 2011, the effective date of the biennial OPEB valuation, follows. There have been no significant changes in the number of covered or the type of coverage since that date.

Active employees	76
Retired employees	36
Deferred vested employees	<u>4</u>
Total	<u><u>116</u></u>

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

10. Deferred Compensation Plan

The Department offers its employees, through the County, a deferred compensation plan established in accordance with Internal Revenue Code Section 457. The plan, available to all full-time Department employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death or an unforeseeable emergency. The plan's assets have been placed in trust accounts with the plan administrators for exclusive benefit of participants and their beneficiaries and are not considered assets of the County or the Department.

In accordance with GASB Statement 32, *Accounting and Financial Reporting Code Section 457 – Deferred Compensation Plans*, the Department has excluded the plan assets from the financial statements. All such amounts are not subject to the claims of the Department or the County's general creditors.

11. Commitments and Contingencies

a. Sick Leave

Accumulated sick leave as of June 30, 2012 and 2011 was approximately \$1,785,000 and \$1,781,000, respectively. Sick leave accumulates at the rate of 14 hours for each month of service, as defined, without limit. Sick pay can be taken only in the event of illness and is not convertible to pay upon termination of employment. As a result, no liability for sick pay is recorded in the accompanying financial statements. However, a public employee who retires or leaves government service in good standing with sixty days or more of unused sick leave is entitled to additional service credit in the ERS.

b. Insurance

The Department is fully self-insured for workers' compensation claims. Such claims are reported to and managed by the County. The Department provides reserves for claims not covered by insurance that in the opinion of counsel will result in probable judgment against the Department. These reserves include an estimate of claims that have been incurred but not reported (IBNR). Claim liabilities, including IBNR, are based on the estimated ultimate cost of settling the claims. Claims liabilities are estimated by a case-by-case review of all claims and the application of historical experience to outstanding claims. As of June 30, 2012 and 2011, the workers' compensation liability amounted to approximately \$114,000 and \$46,000, respectively, and is recorded in accounts payable and accrued liabilities on the accompanying statements of net assets.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

11. Commitments and Contingencies (continued)

c. Safe Drinking Water Act

The Department is subject to the requirements of the Safe Drinking Water Act (the Act) which is administered by the State of Hawaii Department of Health on behalf of the United States Environmental Protection Agency. Management indicated that the Department is in full compliance with the requirements of the Act and is not aware of any matters under the Act that materially affected or is currently affecting the Department's customer service area.

d. Other Legal Matters

The Department is party to various legal proceedings arising in the normal course of business. The outcome of individual matters is not predictable. However, management believes that the ultimate resolution of all such matters will not have a material adverse effect on the Department's financial position or results of operations.

e. Other

Other commitments, primarily for utility plant construction, approximated \$22,580,000 and \$42,463,000 at June 30, 2012 and 2011, respectively.

12. Related Party Transactions

The Department charges the County for fire protection services (hydrant use) at agreed-to rates that approximate the cost for such services. The County provides certain services to the Department and charges the Department for these services at an amount equal to the charge for fire protection services. The amounts charged approximated \$1,148,000 and \$944,000 in 2012 and 2011, respectively.

13. Subsequent Event

On July 10, 2012, the County of Kauai issued approximately \$26 million of Series 2012A general obligation bonds. The Department's share of this issue approximated \$2.7 million, which will be utilized to defease Series 2005A general obligation debt.

Department of Water, County of Kauai

Notes to Basic Financial Statements
June 30, 2012 and 2011

14. New Pronouncements for Financial Reporting

In June 2012, GASB issued Statement No. 68 (GASB 68), *Accounting and Reporting for Pensions (an amendment of GASB Statement No. 27)*. GASB 68 amends the accounting guidance related to employers' accounting for pension plans administered through trusts or similar arrangements and requires the recognition of a liability for the employers' accumulated obligation for pension benefits. GASB 68 also provides additional guidance regarding the recognition of annual costs of pension benefits and revises the disclosure requirements for the notes to the financial statements and required supplementary information. GASB 68 will be effective for the Department's financial statements for the year ending June 30, 2015. Management is currently assessing the impact of GASB 68 on its financial position and results of operations and has not determined if the adoption will have a material effect on its financial statements.

In June 2011, the GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. This Statement provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2011. Management is currently assessing the impact of GASB Statement No. 63 on its financial position and results of operations and has not determined if the adoption will have a material effect on its financial statements.

In December 2010, the GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. This Statement incorporates FASB, APB, and ARB pronouncements, not conflicting with GASB pronouncements, and issued on or before November 30, 1989, into the GASB authoritative literature. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2011. Management does not believe that the adoption of this guidance will have a significant effect on the Department's financial position or results of operations.

Department of Water, County of Kauai

Schedule of Funding Progress for the
Hawaii Employer-Union Health Benefits Trust Fund

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
7/1/2007	\$ -	\$ 8,465,000	\$ 8,465,000	0%	\$ 4,585,000	185%
7/1/2009	930,000	13,531,000	12,601,000	7%	4,424,000	285%
7/1/2011	2,281,000	11,586,000	9,305,000	20%	4,368,000	213%

DRAFT

See accompanying independent auditor's report.

Department of Water, County of Kauai

Schedule I

Supplemental Schedule of Utility Plant in Service
For the Year Ended June 30, 2012

	June 30, 2011				June 30, 2012
	Balance	Adjustments	Additions	Retirements	Balance
Cost Basis:					
Water Utility Plant:					
Source	\$ 8,019,824	\$ -	\$ 15,647	\$ -	\$ 8,035,471
Pumping	35,278,519	-	6,056,902	(2,321)	41,333,100
Water Treatment	9,394,690	-	11,445	(1,586)	9,404,549
Transmission & Distribution	179,006,159	-	33,417,907	(1,658,708)	210,765,358
General	9,877,126	-	627,985	-	10,505,111
Held for Future Use	1,283,036	-	(19,631)	-	1,263,405
	<u>242,859,354</u>	<u>-</u>	<u>40,110,255</u>	<u>(1,662,615)</u>	<u>281,306,994</u>
Land and Land Rights:					
Source	834,338	-	9,008	-	843,346
Pumping	381	-	-	-	381
Water Treatment	150	-	-	-	150
Transmission & Distribution	499,259	-	-	-	499,259
	<u>1,334,128</u>	<u>-</u>	<u>9,008</u>	<u>-</u>	<u>1,343,136</u>
Total	<u>\$ 244,193,482</u>	<u>\$ -</u>	<u>\$ 40,119,263</u>	<u>\$ (1,662,615)</u>	<u>\$ 282,650,130</u>
Accumulated Depreciation					
Water Utility Plant:					
Source	\$ 3,861,553	\$ -	\$ 177,114	\$ -	\$ 4,038,667
Pumping	16,744,733	879	1,359,465	(2,321)	18,102,756
Water Treatment	4,423,637	365	710,125	(1,586)	5,132,541
Transmission & Distribution	51,062,633	1,149,951	3,230,283	(1,658,708)	53,784,159
General	5,397,714	-	297,405	-	5,695,119
Held for Future Use	277,023	-	25,041	-	302,064
Total	<u>\$ 81,767,293</u>	<u>\$ 1,151,195</u>	<u>\$ 5,799,433</u>	<u>\$ (1,662,615)</u>	<u>\$ 87,055,306</u>

See accompanying independent auditor's report.

Department of Water, County of Kauai

Schedule II

Supplemental Schedule of Selective Account Classifications (in 000's)

For the Five Years Ended June 30, 2012

	<u>2012</u>	<u>2011</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>
<u>Balance Sheet:</u>					
Utility plant in service	\$ 282,650	\$ 244,193	\$ 223,914	\$ 204,355	\$ 194,059
Net Assets:					
Invested in capital assets, net	\$ 142,688	\$ 132,139	\$ 124,943	\$ 121,962	\$ 107,914
Restricted for capital activity					
and debt service	3,197	2,483	3,977	5,561	6,544
Unrestricted	24,462	14,494	16,533	9,965	16,417
Total	<u>\$ 170,347</u>	<u>\$ 149,116</u>	<u>\$ 145,453</u>	<u>\$ 137,488</u>	<u>\$ 130,875</u>
<u>Income Statement:</u>					
Resources:					
Water sales	\$ 21,283	\$ 19,829	\$ 18,772	\$ 17,533	\$ 17,200
Other	1,239	970	1,014	842	736
Total	<u>22,522</u>	<u>20,799</u>	<u>19,786</u>	<u>18,375</u>	<u>17,936</u>
Operating Expenses:					
Depreciation	6,163	5,743	5,898	5,182	4,580
Administrative and general	5,115	4,165	4,299	4,192	4,437
Power and pumping	4,015	3,323	3,178	3,139	3,740
Transmission and distribution	3,502	3,017	3,441	3,221	3,655
Accounting and collection	606	591	584	576	533
All other	962	824	1,054	1,134	1,286
Total	<u>20,363</u>	<u>17,663</u>	<u>18,454</u>	<u>17,444</u>	<u>18,231</u>
Non-Operating (Expense) Income	(2,991)	(3,552)	(1,031)	(330)	17
Contributions	22,063	4,079	7,664	6,013	7,952
Increase in net assets	<u>\$ 21,231</u>	<u>\$ 3,663</u>	<u>\$ 7,965</u>	<u>\$ 6,614</u>	<u>\$ 7,674</u>

See accompanying independent auditor's report.

**Independent Auditor's Report on Internal Control Over Financial Reporting and on
Compliance and Other Matters Based on an Audit of Financial Statements Performed in
Accordance with *Government Auditing Standards***

To the Board of Water Supply
Department of Water, County of Kauai:

We have audited the financial statements of the Department of Water, County of Kauai (the Department) as of and for the years ended June 30, 2012 and 2011, and have issued our report thereon dated [DATE]. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Department is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audits, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency described in the accompanying schedule of findings, item 2012-01, to be a material weaknesses.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of findings, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying schedule of findings, items 2012-02 and 2012-03, to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The Department's response to the findings identified in our audit is described in the accompanying schedule of findings. We did not audit the Department's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Board of Water Supply, management, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KMH LLP

Honolulu, Hawaii

[DATE]

Department of Water, County of Kauai

Schedule of Findings

For the Year Ended June 30, 2012

I. Financial Statement Findings

Finding No.: 2012-01

Inadequate Use of Accounting Software – Material Weakness

Criteria: Information systems are an integral part of the control environment. The quality and proper utilization of the information affects management’s ability to prepare reliable financial reports and to make appropriate decisions based on those reports.

Condition, cause & context: For several years, the Department has been in progress with the installation of its accounting software. Although the main modules were fully in place, the implementation of the payroll module was delayed and the Department decided last year not to pursue the implementation of the last module. The Department had installed the system with hopes of increasing its ability to provide timely and accurate financial reporting. Instead the software, as implemented, has not performed as expected. The following are some of the issues noted:

- Too many general ledger accounts;
- Reports not designed to allow for regular financial reporting;
- Significant amount of processing done outside of system – CWIP

In 2012, the Department completed an information technology assessment to determine if a new accounting system should be obtained. Management plans to evaluate this assessment and develop actions steps in 2013.

Effect: Inadequate use of the accounting system puts more pressure on the Departments accounting staff to complete its closing procedures and limits its ability to analyze the information to identify potential errors.

Recommendation: The Department should consider simplifying the current account structure and setup of the financial reporting system during its information technology assessment.

Department Reply: The Accounting staff concurs with the Auditor’s finding and recommendation. The IT review and assessment prioritized a financial system redesign emphasizing a simplified chart of accounts and concurrent data migration to preserve historical information. Report design and project accounting will be addressed as part of this process.

Contact Person: Marites Yano

Target Completion Date: June 30, 2015

Department of Water, County of Kauai

Schedule of Findings
For the Year Ended June 30, 2012

I. Financial Statement Findings (continued)

Finding No.: 2012-02

Timely Reconciliation of Sales Entries – Significant Deficiency

Criteria: Sales entries from HBWS system should be reconciled to the Department’s general ledger on a monthly basis.

Condition, cause & context: We noted during the audit process that management had not reconciled revenues on a timely basis. These reconciliations were not performed until after the end of the fiscal year.

Effect: Timely reconciliations are crucial in determining proper account balances. In addition, this condition contributed to the length of the annual closing process.

Recommendation: Revenues should be reconciled regularly and all related adjustments recorded on a timely basis.

Department Reply: The revenue reconciliations were not completed on timely basis. Therefore, the Accounting staff is in agreement with the auditor’s finding. The project has been reassigned with the expectation that it will be completed before the billing software conversion is complete.

Contact Person: Marites Yano

Target Completion Date: January 31, 2013

Finding No.: 2012-03

Inventory – Book to Physical Adjustments – Significant Deficiency

Criteria: Inventory controls should be in place to minimize significant book to physical adjustments. In addition, compensating monitoring controls should be in place to ensure that all the book to physical adjustments have appropriate explanations.

Department of Water, County of Kauai

Schedule of Findings

For the Year Ended June 30, 2012

I. Financial Statement Findings (continued)

Condition, cause & context: During the course of the audit, we noted a book to physical adjustment of approximately \$91,000 was recorded after the annual physical inventory count. Through our audit procedures, we were able to conclude that materials inventory was properly stated as of year-end. However, management was not able to readily provide an explanation for the adjustment.

Effect: Inadequate monitoring controls over materials inventory can lead to misappropriation of assets being undetected.

Recommendation: Management should review detailed inventory procedures to identify the potential cause of the large adjustments. In addition, management should consider increasing the frequency of the inventory counts.

Department Reply: The Department agrees an inventory adjustment of this size is unacceptable. Management has instituted more frequent inventory counts. Tighter internal control procedures are being explored including a revised Inventory SOP and possible reorganization of relevant staff.

Contact Person: Marites Yano

Target Completion Date: June 30, 2013

Department of Water, County of Kauai

Schedule of Findings

For the Year Ended June 30, 2012

II. Summary Schedule of Prior Audit Findings

This section contains the current status of our prior audit recommendations. The recommendations are referenced to the pages of the previous audit report for the year ended June 30, 2011 dated December 7, 2011.

<u>Recommendations</u>	<u>Status</u>
11-01 Billing Changes and Error Determination	Resolved.
<p>When the Department implemented a rate change for fire safety line customers on July 1, 2010 the water usage rate for these customers was inadvertently doubled. Based on inquiries with management, the Department typically works with the Honolulu Board of Water Supply (HBWS) to run billings in a test environment to ensure that billing changes are applied correctly. However, there was no documentation provided related to this rule change testing results, and the error indicates that the controls did not operate effectively.</p>	
<p>We recommend that the Department should more thoroughly test and document the results of testing of billing changes implemented in the HBWS's billing system.</p>	

Department of Water, County of Kauai

Schedule of Findings
For the Year Ended June 30, 2012

II. Summary Schedule of Prior Audit Findings (continued)

Recommendations

Status

11-02 Financial Analysis

During our testing of revenues, we noted a contradiction between the results of the budget status report and the financial statements. In the Department's June 2011 budget status report total water sales cash receipts was relatively flat when compared with the prior fiscal year while water sales revenues increased by approximately \$2.6 million according to the unadjusted general ledger provided by management. Upon inquiry with management, no sufficient explanation for the difference could be provided. The current waterworks controller was promoted in 2011 and we did note a lack of proper transition for the significant changes to this position and others throughout the Department. Similar to many other government agencies, the difficult transition experienced was due to high turnover rates caused by a large number of individuals electing to retire at the same time.

Resolved.

We recommend that the Department should perform high-level analytical procedures to identify potential financial reporting issues or errors on a regular basis.

Department of Water, County of Kauai

Schedule of Findings
For the Year Ended June 30, 2012

II. Summary Schedule of Prior Audit Findings (continued)

Recommendations

Status

11-03 Inadequate Use of Accounting Software

For several years, the Department has been in progress with the installation of its accounting software. Although the main modules were fully in place, the implementation of the payroll module was delayed and the Department decided last year not to pursue the implementation of the last module. The Department had installed the system with hopes of increasing its ability to provide timely and accurate financial reporting. Instead the software, as implemented, has not performed as expected. The following are some of the issues noted:

- Too many general ledger accounts;
- Reports not designed to allow for regular financial reporting;
- Significant amount of processing done outside of system – CWIP

The Department is in the process of performing an information technology assessment to determine if a new accounting system should be obtained. Management plans to complete this assessment in 2012.

The Department should consider simplifying the current account structure and setup of the financial reporting system during its information technology assessment.

Ongoing. The Department completed assessment of the existing accounting system. Management is current evaluating the results and developing action steps to remedy the gaps identified by the consultant. See finding 2012-01 for current year finding.

Department of Water, County of Kauai

Schedule of Findings
For the Year Ended June 30, 2012

II. Summary Schedule of Prior Audit Findings (continued)

<u>Recommendations</u>	<u>Status</u>
11-04 Timely Reconciliation of Sales Journal	
<p>We noted during the audit process that management had not reconciled revenues on a timely basis. Due to transition of the waterworks controller position in FY2011, these reconciliations were not performed until after the end of the fiscal year.</p>	Ongoing. See finding 2012-02.
<p>Revenues should be reconciled regularly and all related adjustments recorded on a timely basis.</p>	
11-05 Inadequate Review of Supporting Documents	
<p>During the audit of fixed assets, we noted several instances where the workpapers prepared by Accountant IV had errors that could have been prevented. We understand that the position responsible for these schedules was vacant at the time of the audit and that the Accountant IV was doing the work of two positions. When the Accountant IV is the preparer of the schedule, it should be reviewed by the waterworks controller.</p>	Resolved.
<p>Accounting schedules should be reviewed on a timely basis. If the person responsible for the review becomes the preparer, an individual other than the preparer should perform the review, ideally someone at a higher level.</p>	